



Where Will Canadian Pacific Railway (TSX:CP) Stock Be in 5 Years?

Description

Canadian Pacific Railway Limited ([TSX:CP](#))([NYSE:CP](#)) has been a winning bet for decades. Over the past five years, shares have risen by 40% versus a mere 5% rise for the **S&P/TSX Composite Index**.

Since 2006, the stock has exploded higher by more than 420%. Over that period, the S&P/TSX Composite Index rose by just 38%.

No matter how you slice it, Canadian Pacific has been a winner. But what does the future hold? Now priced at 19 times forward earnings, the stock isn't obviously expensive, but it's not cheap either. Let's find out if now is the time to buy, double-down, or walk away.

Where's the growth?

Over the past decade, Canadian Pacific has grown profits by 15.4% per year — a big reason why shares have risen tremendously over the previous 10 years. Here's the catch: revenues over the same period have grown by just 5.1% annually. Why the disconnect?

Clearly, Canadian Pacific has been able to wring out more profit for each dollar of revenue. That's the only thing that can explain how net income can consistently outgrow sales. Indeed, operating efficiencies have been a huge part of the company's growth.

Today, Canadian Pacific can ship goods coast-to-coast faster and cheaper than ever before. Automation improvements have increased output and reduced the need for excess workforce.

There's only one problem: you can't achieve operating efficiencies twice. As soon as the efficiencies are built into the business, their impact is simply maintained, not grown.

With some of the best profitability metrics in the industry, it's not clear that Canadian Pacific can continue its breakneck speed of profit growth, especially given that sales growth hasn't been that impressive.

If earnings growth trends lower over the next five years—a big possibility—the ascribed valuation could take a tumble, which could offset any potential gains investors experience.

Watch the valuation

Your investment returns will ultimately be based on the initial price you pay. Even if Canadian Pacific continues to grow sales and profits for years to come, paying too steep of a premium could erode your performance.

That's because valuation multiples change just as much as profits. In fact, valuation multiples often swing considerably *more* than underlying profits.

From 2006 to 2009, Canadian Pacific stock traded between 8 and 12 times earnings. From 2010 to 2012, the average valuation increased to between 13 and 19 times earnings. Since 2013, the stock's valuation has averaged a historically high 25 times earnings.

This isn't egregious by any means, especially considering the historical rate of profit growth. But it's certainly time to reflect on whether the valuation has gotten ahead of itself.

Over the next three to five years, analysts expect the company to grow earnings by around 11% per year. If that's the case, the current valuation seems very fair. It's easier to argue, however, that actual results will underwhelm.

According to a recent survey, economists believe that there's a 35% chance that the U.S. will enter a recession over the next 12 months. Railroad stocks, which are largely a proxy for economic activity, stumble during recessions.

Over the last two instances (in 2001 and 2008), Canadian Pacific stock fell by 50%, largely on a compression in valuation. Now nearing an all-time high multiple, there's isn't much room for mistakes.

The stock is still promising long-term, but it's likely fully valued. If you're looking for easy money, this isn't the stock for you.

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